Supreme Court, U. S.
FILED
APR 10 1975
MICHAEL RODAK, JR., CLERK

No. 74-121

In the

Supreme Court of the United States

OCTOBER TERM, 1974

CRAIG PHELPS, RECEIVER IN BANKRUPTCY IN THE MATTER OF CHICAGOLAND IDEEL CLEANERS, INC., BANKRUPT,

Petitioner,

vs.

UNITED STATES OF AMERICA,

Respondent.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT

REPLY BRIEF OF THE PETITIONER

KEVIN J. GILLOGLY
Suite 865
One North LaSalle Street
Chicago, Illinois 60602
Attorney for Petitioner

Of Counsel:
DANIEL C. AHERN
DENNIS E. QUAID

The Scheffer Press, Inc.—(312) 263-6850

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ARGUMENT

I. THE UNITED STATES DOES NOT ENJOY A TAX LIEN ON THE BANKRUPT'S PROPERTY, OR THE PROCEEDS THEREOF, AND SERVICE OF THE NOTICE OF LEVY WAS INEFFECTIVE TO CONFER CONSTRUCTIVE POSSESSION ON THE UNITED STATES.

Upon the assignment by Chicagoland Ideel Cleaners, Inc., of its property to the assignee, the property interest of the corporation was terminated under the law of the State of Illinois. That fact, taken in conjunction with the intervention of the rights of *bona fide* purchasers from the assignee prior to the recordation of the Notice of Tax Lien or the service of the Notice of Levy upon the assignee, are the circumstances which prevent the United States from enjoying the rights of a lienholder in this case. This Court in *United States* v. *Bess*, 357 U.S. 51, 78 S.Ct. 1054, 2 L. Ed. 2d 1135 (1958) recognized and gave effect to the invalidity of a tax lien on the proceeds of property subject to a tax lien when the property interest of the taxpayer terminated, creating a fund for the benefit of third persons. The Respondent completely misinterprets the holding of *United States* v. *Bess*, *supra*. The tax lien therein did not follow and attach to the proceeds of the life insurance policy, being the face amount of the policy, for the reason that the taxpayer enjoyed no property interest in the proceeds of the policy as he had enjoyed in the policy prior to death. The statement of the Respondent (R. Br. 17) taken out of context of the full opinion only held that the cash surrender value of the policy was a fund accumulated for the benefit of the taxpayer and was subject

to his dominion prior to death. It did not mean as the Respondent would have the Court believe that the lien followed and attached to all the proceeds. In the case at bar, the Respondent seeks to assert a tax lien upon the proceeds of the assignee's sale, a fund in which the taxpayer had no property interest. Framed in the context of the *Bess* holding, the government wants the face amount of the policy. *Bess* held against this proposition.

The recordation of the Notice of Tax Lien and service of the Notice of Levy subsequent to the assignment and assignee's sale came too late to help the Respondent's position. The tax lien is invalid as to purchasers whose rights arise prior to the recordation of the Notice of Tax Lien, Section 6323(a) of the Internal Revenue Code of 1954, 26 U.S.C. 6323(a), and when the requisite notice was recorded, there no longer existed any property or rights to property belonging to the taxpayer or subject to the lien. The purported levy was also ineffective for the reason that it operates only upon property of the taxpayer or subject to the lien, Section 6331(a) of the Internal Revenue Code of 1954, 26 U.S.C. 6331(a).

Contrary to the Respondent's assertion (R. Br. 17) that it would be deprived of its legitimate rights as a lienholder, any diminution of its rights resulted from a failure to diligently assert those rights. As the holder of an unperfected and secret tax lien, the Respondent failed to promptly assert and protect its rights from the intervention of third parties such as *bona fide* purchasers without knowledge or the initiation of a bankruptcy proceeding. Instead, the Respondent waited until the assignee had liquidated the property and then sought to reveal and assert its secret lien upon the proceeds, saving to itself the efforts and expenses of liquidation. The Respondent cannot sit upon its rights hoping to gain

an advantage and then complain that its rights have been jeopardized by its own delay. Further, the hypothetical situation propounded by the Respondent (R. Br. 17) lacks any conformance to the situation in this case. The assignee for the benefit of creditors was a trustee for creditors and not a mere donee. In his hands, the taxpayer had no property interest or power to recover his former property. The assignment created a new relationship between the assignee and creditors which cannot be duplicated by a transfer to a mere donee. The termination of the property interest of the taxpayer and creation of a special fund for creditors, acted to defeat the tax lien.

Throughout its argument, the Respondent labels the assignee as an agent or bailee of the taxpayer, or as a custodian of the government upon service of the Notice of Levy. Such arguments disparage the trust relationship existing between the assignee and the assignor's creditors as recognized by Illinois law. That relationship cannot be altered by the service of a Notice of Levy, even assuming it to be valid, upon property held by the assignee. Whatever the power of the Internal Revenue Code, changing valid state-created relationships is not encompassed therein.

In summary, the assignment terminated the property interest of the taxpayer in the assets and the sale by the assignee prior to perfection by the United States of its lien created a special fund unencumbered by the tax lien. The purported levy was ineffective, wanting any property of the taxpayer or subject to a lien upon which to operate. Under such circumstances, no possession, constructive or actual, could be obtained by the Respondent.

II. IN THE ABSENCE OF CONSTRUCTIVE POSSESSION BY THE UNITED STATES, THE BANKRUPTCY COURT OBTAINED SUMMARY JURISDICTION OF THE PROCEEDS OF THE ASSIGNEE'S SALE UPON INITIATION OF THE BANKRUPTCY PROCEEDING.

As a consequence of the failure of the Respondent's lien to attach to the proceeds of the assignee's sale, the Notice of Levy was ineffective, Section 6331(a). Pursuant to the provisions of that section of the Internal Revenue Code of 1954, a levy is completely dependent upon the validity of the lien or a property interest of the taxpayer. However, due to the delay of the Respondent, neither existed when the Notice of Levy was served. Consequently, the Respondent did not obtain constructive possession of the proceeds, nor does the Respondent have any right to rely upon its levy in order to give it constructive possession (R. Br. 24) under these circumstances. The intervention of rights of third parties such as the taxpayer's creditors under the assignment and that of the assignee's purchasers, alter this case from a simple levy upon the taxpayer's property or funds in the hands of mere custodians or debtors of the taxpayer. Here, the funds were now held for all creditors and the right of the taxpayer to recover the property on demand had terminated. Such circumstances distinguish and remove this case from that of a levy upon the taxpayer's bank, at which it maintains its account, or debtors who assert for themselves no claim to the property. In the latter situation, the Respondent would be correct; in the former which is before the Court, the proposition is erroneous.

The Respondent further asserts (R. Br. 24) that in the event it cannot rely upon a levy upon intangible personal property to confer constructive possession, the

government would be forced to engage in an "unseemly scramble for actual possession". What the Respondent describes as an unseemly scramble is merely a requirement that the United States perfect and assert its rights, before the intervention of third party rights. This is especially true when its rights arise from a secret lien which has the effect of inducing general creditors to continue to do business and extend credit to the taxpayer. It would be oppressive for the United States to create by administrative action its secret lien; allow the taxpayer to continue to operate on credit from general creditors; await a liquidation of the property by an assignee at no expense or effort to the government; and, then, to perfect its lien and simultaneously claim the proceeds. Yet, this is the position of the Respondent. In order to prevail, the United States must comply with its own statutes, Section 6323 of the Internal Revenue Code, by perfecting and giving notice of its lien and taking actual possession of the property before it passes to third parties. A contrary result would allow the United States to reap the benefits of its statutory rights without complying with the pre-conditions to those rights.

III. ASSUMING THAT THE UNITED STATES ENJOYED A VALID LIEN, THE TAX LIEN WAS POSTPONED TO COSTS OF ADMINSTRATION AND PRIORITY WAGE CLAIMS BY SECTION 67c(3) AS NOT BEING ACCOMPANIED BY POSSESSION.

The evolving Congressional concern over tax liens consuming such a great portion of bankruptcy estates that costs of administration and priority wage claims are not being satisfied has manifested itself in Section 67c(3) of the Bankruptcy Act, 11 U.S.C. 107c(3). This provision postpones tax liens to costs and priority wage claims when the lien is not accompanied by possession, which

is defined as actual possession. *Goggin* v. *Division of Labor Law Enforcement*, 336 U.S. 118, 69 S. Ct. 469, 93 L. Ed. 543 (1949). Even assuming that the Notice of Levy would confer constructive possession upon the United States, the lien would still be postponed to costs and priority wages. It might also be mentioned that the taxpayer's property consisted of tangible personal property subject to actual and physical seizure at the time of the assessments and thereafter. Rather than seize the property, the Respondent waited until it had been liquidated into cash by the assignee. Consequently, the United States should not be heard to complain concerning the difficulty of taking actual possession of intangible personal property.

The Respondent also asserts (R. Br. 26) that Section 67c(3) is inapplicable for the reason that the provision applies to liens but not levies. A levy is a device to enforce a lien and has no independent significance. The rights of the Respondent depend upon its lien and are subject to the effect of Section 67c(3) upon that lien.

IV. THE UNITED STATES IS NOT ENTITLED TO SPECIAL CONSIDERATION IN THIS PROCEEDING WHICH IS NOT AN ACTION TO RESTRAIN THE COLLECTION OF TAXES.

The Receiver's application sought to invoke the summary jurisdiction of the Bankruptcy Court over an assignee for the benefit of creditors. The United States chose to intervene in that action to assert its alleged tax lien, rather than rely under the penalty provisions of the Internal Revenue Code, Section 6332(c) and (d), 26 U.S.C. 6332(c) and (d). The United States' affirmative intervention distinguishes this case from *N.H. Fire Insurance Co.* v. *Scanlon*, 362 U.S. 404. It is also inconsistent that the Respondent relies (R. Br. 11) upon the summary

nature of the administrative proceedings which create its lien but object to the exercise of summary jurisdiction in a proceeding in which it intervened.

The claim that this proceeding sought to restrain the collection of taxes (R. Br. 32-33) fares no better. This proceeding concerns the alleged tax *lien*, not the underlying taxes. Upon bankruptcy, adequate measures have been provided to enable the United States to collect its taxes from the remaining assets of the bankrupt and a priority has been granted to those taxes. The Respondent is welcome to participate in the bankruptcy proceeding and seek a dividend based upon its claim.

V. THE POLICY OF THE BANKRUPTCY ACT SHOULD GUIDE THE COURT IN RESOLVING THIS CONTROVERSY.

The difficulty of this case is caused by the conflicting policies of the two federal statutes involved, the Bankruptcy Act and the Internal Revenue Code of 1954. The special consideration which the United States claims in this proceeding for the purpose of the expeditious collection of revenue is not usually countervailed as it is in this case. The question of priority of payment in collective insolvency proceedings is within the special province of the Bankruptcy Act. *United States* v. *Randall,* 401 U.S. 513, 91 S. Ct. 991, 29 L. Ed. 2d 273 (1971). Congress has created special powers and protections in the Internal Revenue Code to assure the collection of taxes, but when dealing with the subject of taxes and liens in bankruptcy proceedings, has acted to limit and restrict those broad powers and rights by postponing liens not accompanied by possession to costs and priority wages, Section 67c(3) of the Bankruptcy Act, 11 U.S.C. 107c(3), and providing for a partial discharge of taxes, Section 17a(1) of the Bankruptcy Act, 11 U.S.C. 35a(1). Therefore, the scope

and nature of a federal tax lien should for the purpose of this case be determined within the context of the Bankruptcy Act which contains a carefully considered set of priorities and treatment of taxes. Only the Bankruptcy Act considers both priorities and the treatment of taxes in collective insolvency proceedings. The Respondent should be strictly held to the statutory and judicially imposed limits of a federal tax lien and the pernicious theory advanced in *United States* v. *Eiland,* 223 F. 2d 118 (4th Cir. 1955) that a levy transfers ownership of intangible personal property without the prior perfection of the lien should not be utilized, as the Respondent has attempted to do, for the purpose of overriding the priorities established in the Bankruptcy Act. This is the basis of the ruling of the Court of Appeals for the Ninth Circuit in *In Re United General Wood Products Corp.,* 483 F. 2d 975 (9th Cir. 1973) which should be applied to the case before this Court.

CONCLUSION

The Petitioner respectfully urges this Honorable Court to reverse the judgment of the United States Court of Appeals for the Seventh Circuit and to uphold the order of the Bankruptcy Court.

Respectfully submitted,

KEVIN J. GILLOGLY
One North LaSalle Street
Chicago, Illinois 60602
Attorney for Petitioner

DANIEL C. AHERN
DENNIS E. QUAID
Of Counsel